1-7-2016

# Prehn v. Hodge Respondent's Brief Dckt. 42465

# IN THE SUPREME COURT OF THE STATE OF IDAHO



DONNELLY PREHN and DWIGHT BANDAK,

Plaintiffs-Respondents,

vs.

THE SOURCE STORE, LCC; THE SOURCE, LLC; MICHAEL L. HODGE II, GEORGE M. BROWN; and CHRISTOPHER CLAIBORNE,

Defendant-Appellant.

SUPREME COURT DOCKET NO. 42465

## RESPONDENT'S BRIEF

Appeal from the District Court of the Fourth Judicial District of the State of Idaho,

District of the State of Idaho, in and for the County of Ada

Honorable Patrick H. Owen, District Judge Presiding

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## STATEMENT OF THE CASE

The gravamen of this appeal is based upon Appellant's failure to timely object to Respondent's derivative claims in clear violation of the district court's scheduling order without good cause. Procedural deficiencies aside, Appellant's contention that the derivative claims of Respondent should have been brought as direct claims is without merit and Respondent's pleadings properly alleged derivative claims, of which demand upon the members constituting the majority of the company would have been futile. To wit, the district court clearly considered Appellant's legal argument on the merits at trial and ruled against them.

Both Donnelly Prehn and Dwight Bandak (hereinafter "Prehn" and "Bandak" and cumulatively "Respondent") were not only representative of the aggrieved class of the company ("Source 1"), they in fact constituted the entire class as aggrieved minority interest holders. The remaining majority members were in the process of forming a competing company ("Source 2") and were all actively diverting business from Source 1, as well as fixing the dissolution auction after they concurrently used their 51% membership interest to elect Hodge as liquidator of Source 1. As such, Prehn and Bandak were clearly adequate representation of similarly effected members because they were the only members who would act to enforce the rights of Source 1.

Furthermore, demand of Source 1 to enforce the rights of aggrieved shareholders would have been futile, as Michael Hodge (hereinafter "Hodge") and the two remaining members constituting the majority of interest holders in Source 1 were clearly not disinterested nor likely to act in the best interests of Source 1, as doing so would be to the detriment of their competing company in Source 2 that they formed before dissolving Source 1.

Finally, Appellant mischaracterizes the substantive requirements of derivative claims. Namely, plaintiffs in a derivative claim need not be disinterested and often are not. The "disinterested" requirement applies only to those controlling the company and their ability to remain unbiased in assessing whether or not to pursue claims for the benefit of the company over their personal interests. Further, contrary to Appellant's argument, the existence of direct claims brought by a shareholder does not preclude that same member from also bringing derivative claims for other causes of action.

Accordingly, the district court properly ruled that Respondent's derivative claims were proper under Idaho Code § 30-6-904 and Appellant's appeal should be denied.

## FACTUAL BACKGROUND

Source 1 was established by Prehn and Hodge in 2002 as an Idaho limited liability company after initially being a sole proprietorship. R., p. 758, Ll. 19-20, p. 759, Ll. 1-2. Hodge was the sole managing member of Source 1 upon the conversion to a limited liability company until the time of its dissolution. R., p. 760, Ll. 4-5. Eventually George M. Brown ("Brown"), Christopher Claiborne ("Claiborne") and Bandak also became part owners of Source 1. R., p. 759, Ll. 11-13. When Source 1 was dissolved, Prehn and Bandak owned approximately 49% of Source 1. R., p. 759, Ll. 13-15. Hodge, Brown and Claiborne collectively owned approximately 51%. *Id.* Hodge's interest was 39.637% and Prehn's interest was 37.975%. *Id.*

Source 1 was in the business of developing, designing, producing and selling merchandise and apparel for promotional and marketing purposes. R., p. 759, Ll. 3-6. Although there were numerous years that were not profitable initially, Source 1 grew into a profitable company, particularly in 2010 and forward. R., p. 760, Ll. 6-20. In the earlier years of the company, Prehn took a back-salary with the understanding it would be paid back to him when profitable and loaned Source 1 substantial sums to keep the company economically viable before reaching profitability. R., p. 760, Ll. 6-17. The back-salary remaining at dissolution was $67,500 and the loan balance remaining owed to Prehn at dissolution was $79,232.51, plus 10% interest accruing from January 1, 2011. R., p. 771, Ll. 1-12.

Prehn and Hodge worked together for a number of years to grow the company, but Prehn's growing concerns over time with Hodge's management lead to considerable tension. R., p. 760, Ll. 1-5. Prehn stopped working as a full-time employee of Source 1 at the end of 2010 and Hodge continued to work full time. *Id.* After proposed buy-outs fell through between Prehn and Hodge, the members of Source 1 voted unanimously to dissolve the company on April 4, 2012. R., p. 761, Ll. 11-18; *see also* Def. Exh. 1044. Hodge was voted to be the liquidator upon a majority vote of Hodge, Brown and Claiborne over Respondent's objections. R., p. 763, Ll. 4-6.

Hodge made it known that he intended to compete against Source 1 prior to dissolution

though both he and Prehn were subject to mutual non-compete agreements. R., p. 763, Ll. 17-18. It was later resolved that the non-competes would mutually expire on the date of the dissolution after the auction. R., p. 124, ¶ 6.

However, before of dissolution of Source 1, a Certificate of Organization for Source 2 was filed on April 16, 2012, with the Idaho Secretary of State listing Hodge, Brown and Desiree Claiborne (Claiborne's wife) as members. R., p. 763, Ll. 12-15. Hodge is the majority owner and sole manager of Source 2. *Id.* Hodge immediately developed Source 2 and began competing against Source 1 before the company had wound-up and before the auction. Def. Exh. 1049, 1051, 1054; Pl. Exh. 54-62, 68. Because of the potential for self-dealing and conflicts of interest of Hodge as both the liquidator and competitor of Source 1, both Prehn and Bandak abstained from voting Hodge as liquidator and expressed these concerns numerous times. R., p. 136, ¶ 46.

Shortly after the vote to dissolve, Source 1 received a large purchase order on April 9, 2012, from BodyBuilding.com, its largest customer. R., p. 768, Ll. 1-6. The purchase order was for $233,481.84 and was made before Source 1 was dissolved. *Id.* Without disclosing the large order until a later date, the decision was made by Hodge to only process purchase orders made up to the date that the members voted approving the dissolution of Source 1 and he decided to not fulfill the BodyBuilding.com order through Source 1. Def. Exh. 1058. Hodge shortly thereafter solicited the order prior to the expiration of his non-compete and fulfilled this identical order through Source 2 approximately two months later. R., p. 768, Ll. 5-6; p. 776, Ll. 1-7; Pl. Exh. 32, 42, 76, 75.

Hodge had also previously indicated that he had "not diverted any orders to any other company and our [sic] in compliance with our operating agreement" despite numerous emails between Hodge, other Source 1 employees, and Bodybuilding.com later being discovered regarding the $233,481.84 purchase order in the days preceding this statement. *See* Def. Exh. 1058; Pl. Exh. 54-56, 58-61, 62, 68.

On April 27, 2012, Respondent filed this action, which contained direct claims by Prehn for his back-salary and loans to Source 1, as well as derivative claims on behalf of Source 1 against Hodge, Brown, Claiborne and Source 2. R., p. 763, L. 20. Claiborne and Brown were

voluntarily dismissed before trial. *See* R., pp. 643-49. Though Respondent sought a temporary restraining order, the parties stipulated to the Order RE: Dissolution entered into on May 12, 2012 that was to govern the winding down of the company. R., p. 123, ¶ 4.

*Inter alia*, the Order RE: Dissolution provided that Source 1 was to process existing purchase orders as part of the winding-up of company affairs and to minimize overhead in an effort to maximize returns. R., p. 123-24, ¶ 4. Further, it was agreed that an auction would be held to sell the assets of Source 1. R., p. 124 ¶ 5.

Leading up to the date of the auction, numerous issues arose. The gravest concern of Respondent was that Hodge would be the liquidator at the auction after forming a competitive company and as such, he had material conflicts of interest with his roles as sole manager and liquidator of Source 1, while at the same time acting as sole manager and majority member of Source 2. R., p. 136, ¶ 46.

Respondent was also concerned with the bidding process proposed by Hodge as liquidator since both Hodge and Prehn would be bidding. TR., pp. 318, Ll. 17-25; TR p. 319, Ll. 1-10. Hodge had proposed that auction bids be sent to him as liquidator and then he would subsequently submit his final bid after seeing all final bids. *Id.* The process was finally changed so the bidders would not see the final bids and would instead submit two initial bids that all bidders could see, and then one final blind bid. TR., pp. 318, Ll. 20-25.

The auction was parceled out into separate asset lots and the final bids by Prehn and Hodge for the lots were as follows:

Shaker cup molds:
Hodge: $40,200
Prehn: $96,000

Embroidery machines:
Hodge: $10,010
Prehn: $ 9,000

Office inventory:
Hodge: $ 6,000
Prehn: $15,100

Intellectual Property:

Hodge: $44,200
Prehn: $ 5,100

All of lots 1-4:
Hodge: $105,010
Prehn: $125,200

R., pp. 765, Ll. 11-25; p. 766, Ll. 1-20. The description of the shaker cup molds and intellectual property in advance of the auction were as follows respectively:

> "Shaker cup molds. This will consist of all 5 of the molds that are use [sic] at Technology Plastic to complete the "Patriot Shaker."
>
> "Intellectual property. This will consist of all goodwill in the company as well as all nontangible property of The Source Store, LLC. This will include all names, logos, concepts, artwork, product names, website, Facebook, race concept. If there is any other intellectual properties that the membership would like to suggest, please submit that request before Friday."

Def. Exh. 1062. Because of the shaker cup mold description describing the mold in relation to production of the cups and was valued by Hodge to be worth between $40,000-50,000, it was presumed by Prehn that the lot would include the right to continue to use the molds to manufacture the shaker cups. R., p. 766, Ll. 9-10; Pl. Exh. 66. The shaker cup molds scrap value was valued at only $1,900. R., p. 766, Ll. 10-11.

During the bidding process for the intellectual property, Hodge placed two initial bids of $5,000.00 and then raised his final bid to $44,200.00. TR., p. 344, Ll. 1-5. After the auction, Hodge's counsel purported that Prehn had no right to use the mold to manufacture the shaker cups because he deemed it to contain the intellectual property he obtained at auction. *Id.*; TR., pp. 156-171; Pl Exh. 66, 71 and 73. Hodge's counsel then sent a letter to Respondent's intended manufacturer instructing that it could not manufacture the shaker cups using the molds, which precluded Respondent from using the molds for production. Pl. Exh. 73.

Without the ability to use the mold to manufacture the cups, the shaker cup molds were essentially valueless. R., p. 623, Ll. 6-10. As such, Prehn placed the funds associated with his bid in trust with his counsel due to Hodge's assertion that Prehn could not use the molds for manufacturing. R., p. 716. Hodge treated this action as a failure to pay the invoice and awarded all lots to himself at the total price of $105,010 as the next highest bidder. R., p. 766, Ll. 9-20.

Following the auction, Hodge submitted a Report of Winding Up with the district court claiming a net operating loss of $620.00 and cash on hand of $20,547.86, which he claimed was subject to ongoing litigation expenses. R., p. 769, Ll. 8-13. No distributions or payments have been made to the members after the auction. *Id.*

Section 14.2 of Source 1's operating agreement, in accord with the Order RE: Dissolution, controlled the liquidation process. Pl. Exh. 1, § 14; R., p. 761, L. 18; p. 762, Ll. 1-22; p. 763, Ll. 1-4; R., p. 479. Among the relevant provisions of this section was that auction proceeds were to first be applied to creditors of the company, including members pursuant to Section 14.2(i). R., p. 762, Ll. 13-22. Despite this provision, proceeds from the Source 1 auction were not applied by Hodge to Prehn's loan or back-salary. R., p. 771, Ll. 7-12.

Section 14.2 of the operating agreement and the Order RE: Dissolution also charged Hodge with the duty of minimizing expenses during dissolution and maximizing return to members. Pl. Exh. 1, § 14.2; R., p. 123-24; R., p. 479. Issues arose from excessive costs incurred during the dissolution process, namely the general and administrative costs. *See* R., p. 773, Ll. 8-20; p. 774, Ll. 1-2. For the years 2010, 2011 and the January-March period of 2012, general and administrative expenses consistently represented between 24.24% - 27.62% of total sales. *Id.* In stark contrast, these expenses represented 43.03% of total sales during the dissolution period. *Id.*

Previously, Hodge and Brown had represented that general and administrative costs should have been considerably lower than historical averages during the dissolution process with reduced overhead. R., p. 774, Ll. 4-14. To the contrary, costs spiked during this period substantially. *Id.* During the dissolution period, Hodge was actively working to grow Source 2 and generated over 1 million dollars in sales for his competing company. *Id.* Simultaneous to taking a mere $9,999.97 salary from Source 2, Hodge paid himself a $103,386.00 salary from Source 1. R., p. 778, Ll. 7-9.

Leading up to trial, intensive discovery was performed by the parties. The deadline set by the District Court for all dispositive motions was February 1, 2013. R., p. 2, Order Governing Proceedings and Setting Trial entered on September 26, 2012. One month after the district court's scheduling order deadline for dispositive motions, Appellant filed a Motion to Dismiss

Derivative Claims on March 1, 2014, one month before the original trial date. R., pp. 536-71. The district court did not hold a hearing on the motion at the at the original trial date due to its untimeliness, but vacated the trial and allowed Appellant to argue the motion at the later trial date, which was then substantively ruled upon in the district court's Findings of Fact and Conclusions of Law. R., p. 777, Ll. 8-15.

At trial, the District Court ruled that Hodge breached his fiduciary duties to Source 1 and its members for numerous reasons, including failing to minimize the costs of dissolution, his orchestration of the asset auction, and for the usurpation of corporate opportunities in diverting Source 1 purchase orders to Source 2. R., pp. 771-81. Further, it found that Source 2 was unjustly enriched by the actions of Hodge and that Hodge was "grossly overcompensated" as the liquidator for Source 1. R. pp. 778, Ll. 14-22; 779, Ll. 1-10. Appellant now brings this appeal. R., p. 1098.

**ISSUES PRESENTED ON APPEAL**

I. Did the district court err as a matter of law in denying Appellant's untimely Joint Motion to Dismiss Derivative Claims and finding that Respondents properly pleaded and asserted a derivative claim on behalf of Source 1 against Hodge?

II. Did the district court err as a matter of law in finding that Hodge breached his fiduciary duties to Source 1 and its members in the manner that he orchestrated the asset auction?

III. Did the district court err as a matter of law in finding that Hodge breached his fiduciary duties to Source 1 and its members in failing to minimize the costs of completing existing purchase orders per the Source 1 operating agreement, the district court's Order RE: Dissolution and applicable Idaho law?

IV. Did the district court err as a matter of law in its award of attorney fees under Idaho Code § 12-120(3) against Hodge in favor of Source 1?

V. Did the district court err as a matter of law in awarding Respondent's their attorney fees pursuant to Idaho Code § 30-6-906(2) in addition to Source 1's recovery of damages?

## LEGAL ARGUMENT

### I. STANDARD OF REVIEW

The standard for reviewing a trial court's legal conclusions is *de novo*. "Review of a trial court's conclusions following a bench trial is limited to ascertaining whether the evidence supports the findings of fact, and whether the findings of fact support the conclusions of law." *Borah v. McCandless*, 147 Idaho 73, 77, 205 P.3d 1209, 1213 (2009).

The standard of review applied to a trial court's findings of fact is a clearly erroneous standard. Accordingly, this Court may only set aside a trial court's findings of fact if they are found to be clearly erroneous. I.R.C.P. 52(a) ("[f]indings of fact shall not be set aside unless clearly erroneous"); *see also Hodgins v. Sales*, 139 Idaho 225, 229, 76 P.3d 969, 973 (2003).

The trial court's findings of fact are construed liberally, as "it is within the province of the trial court to weigh conflicting evidence and testimony and judge the credibility of witnesses." *Oregon Mut. Ins. Co. v. Farm Bureau Mut. Ins. Co. of Idaho*, 148 Idaho 47, 50, 218 P.3d 391, 394 (2009). As such, the reviewing court will not ordinarily disturb findings of fact on appeal that are supported by substantial and competent evidence, even if there was conflicting evidence at trial. *Panike & Sons Farms, Inc. v. Smith*, 147 Idaho 562, 565-66, 212 P.3d 992, 995-96 (2009).

As for attorney fees, the district court's decision to award attorney fees and costs may only be set aside upon showing an abuse of discretion. *Bailey v. Sanford*, 139 Idaho 744, 753, 86 P.3d 458, 467 (2004).

### II. The District Court ruled correctly in ultimately denying the Joint Motion to Dismiss Derivative Claims and finding that as a matter of law Respondents properly pleaded and asserted a derivative claim on behalf of Source 1 against Hodge

The District Court correctly denied Appellant's Joint Motion to Dismiss Derivative Claims (hereinafter "Motion") both procedurally and substantively. Appellant submitted this dispositive Motion well after the district court's scheduling deadline to submit dispositive motions, leaving Respondent almost no time to properly reply to the Motion before the scheduled trial date. Despite Appellant's untimeliness and never pleading failure to state a demand as an

affirmative defense, it is clear from the record that the Motion was nonetheless considered by the district court at trial but was denied on the merits substantively.

To wit, the Motion was properly denied from a substantive perspective, as Respondent complied with the statutory requirements for proceeding with a derivative claim and thoroughly pleaded the factual and legal bases for a derivative claim. A demand by Respondent as the minority membership interest would have been futile and Respondent's complaint is replete with case-specific facts indicating that a demand would have been futile.

**A. Even though the district court did consider the merits of the Appellant's Joint Motion to Dismiss Derivative Claims at trial, the Motion would be properly denied because it was untimely and in clear violation of the district court's scheduling order.**

Pursuant to I.R.C.P. 16(b), the district court issued a scheduling order (the "Order") on September 25, 2012, that governed the proceedings leading up to trial. The Order stated that "all dispositive motions, in addition to all other pretrial motions, shall be submitted by February 1, 2013." Despite this clear Order, Appellant submitted its Joint Motion to Dismiss Derivative Claims on March 1, 2013, without requesting a modification or seeking leave to file the Motion. Furthermore, Appellant did not plead the failure to make demand pursuant to I.R.C.P. 26(f) as an affirmative defense, nor did it attempt to compel an investigation via Idaho Code § 30-6-905.

A scheduling order may only be modified for good cause. *Weinstein v. Prudential Prop. & Cas. Ins. Co.,* 149 Idaho 299, 310, 233 P.3d 1221, 1232 (2010). The determination of what constitutes "good cause" is within the sole and sound discretion of the trial court. *Mercy Med. Center v. Ada Cnty.*, 146 Idaho 226, 230, 192 P.3d 1050, 1054 (2008). When a party makes an untimely motion without seeking modification of the Order, the district court may deny the motion based on untimeliness alone. *See Johnson v. Mammoth Recreations, Inc.*, 975 F.2d 604, 608-09 (9th Cir. 1992) (citing *Jauregui v. City of Glendale,* 852 F.2d 1128, 1133-34 (9th Cir. 1988); *U.S. Dominator, Inc. v. Factory Ship Robert E. Resoff,* 768 F.2d 1099, 1104 (9th Cir. 1985)). Idaho law appears to be in unison with this principle. *See Maroun v. Wyreless Sys.,* 141 Idaho 604, 613, 114 P.3d 974, 983 (2005) (upholding the denial of a motion submitted after the scheduling order deadline when there was no abuse of discretion and the non-movant would have

been prejudiced).

In assessing whether good cause has been shown for the modification of a scheduling order, the primary inquiry is the diligence of the party seeking to submit an untimely motion. *See Robinson v. Twin Falls Highway Dist.,* 233 F.R.D. 670, 672 (D. Idaho 2006) (Winmill, C.J.) ("If the moving party **was not diligent, the inquiry should end**.") (emphasis added). In *Robinson*, it was held that knowledge of the facts that form the bases of the amendment prior to the scheduling deadline "precludes a finding of due diligence." *Id.* Relief will be denied upon a finding that diligence was not exercised. *See Johnson*, 975 F.2d at 609 ("carelessness is not compatible with a finding of diligence and offers no reason for a grant of relief").

In this instance, Appellant has failed to demonstrate any diligence that would support a showing of good cause to modify the Order. From the very initiation of this lawsuit, it was clear that Respondent's complaint contained derivative claims and that Respondent pleaded that demand would be futile for reasons more specifically stated *infra*. *See* R., pp. 16-41, First Amended Complaint ¶¶ 65, 73, 82, 95, 103, 110, 115, 120, 127, 140. There were no additional facts or change in circumstances from the time the lawsuit was filed to the time the Motion was submitted that would excuse Appellant's untimely filing. Appellant failed to timely contend that derivative claims were improper, he never requested to modify the Order, and he has yet to proffer why good cause existed to allow the untimely Motion to be considered.

Simply stated, Appellant has not offered good cause for the untimely Motion because none exists. Appellant could have raised failure to make demand as a defense at any time from the filing of this lawsuit on April 27, 2012, leading up to the February 1, 2013 deadline, but failed to do so. Appellant and his counsel were intimately aware of the facts forming the bases of Respondent's derivative claims even before the filing of this lawsuit and had more than sufficient time to submit the Motion before the deadline of the Order. Due to this knowledge, Appellant and his counsel were well aware that derivative claims had been pleaded and failed to exercise diligence in objecting to the derivative claims prior to the deadline for dispositive motions.

Furthermore, the district court was well within its discretion to refuse consideration of the Motion at that time given the potential for great prejudice to Respondent. Although prejudice to

the non-moving party is not dispositive, it is a highly weighted factor to be considered. The Motion was filed less than a month from the time trial was to occur and did not give Respondent adequate time to respond to a motion that would dismiss the vast majority of Respondent's lawsuit. Substantial and expensive discovery had already been performed leading up to trial under the pretense that Appellant did not object to the nature of Respondent's derivative claims. To dismiss the derivative claims at the last minute, then or now upon appeal, would cause undue prejudice and great expense to Respondent.

Despite the untimely filing, at the April 1, 2013 hearing, the district court indicated that although there would be no hearing at that time due to the untimely motion, the court articulated that Appellant may argue its case against the nature of Respondent's derivative claims at trial and that it would consider such arguments in its ruling. The district court only indicated that the Motion would not be considered for the purposes of any pre-trial ruling, but that Appellant would be permitted to admit evidence and argue against Respondent's pleading of derivative claims. Upon this indication, Appellant's counsel stated based upon the district court's opportunity given to substantively argue the issue at trial, they were content to rest on the pleadings.

Although the district court had clear authority to deny the Motion due to its untimeliness alone, the Motion was considered by the district court at trial, and was denied on substantive grounds in the district court's Findings of Fact and Conclusions of Law:

> "**Having reviewed the Amended Complaint, the Court will find that Plaintiffs have sufficiently pled circumstances that would constitute futility. The Court also find [sic] that these circumstances were proven at trial. Prehn and Bandak may maintain derivative claims on behalf of Source 1**."

R., p. 777, Ll. 11-14. (emphasis added). Despite Appellant deploring that there was no hearing originally on the Motion, full arguments on the merits were afforded to Appellant at trial and admissible evidence thereof were permitted at trial and ruled upon by the district court in reaching its ruling. Appellant may be dissatisfied with the outcome of district court's ruling but that outcome was not predicated by a failure to be heard before trial.

Therefore, Appellant has not been robbed of a chance to be heard as he contends. Rather, the Motion was ultimately considered at trial and was denied properly on substantive grounds.

Accordingly, Appellant's arguments stating that they were not adequately heard on the Motion are misguided.

**B. Appellant's position of neutrality to the derivative claims throughout the lawsuit and failure to seek redress under the Idaho LLC Act bar him from now objecting to the nature of the derivative claims.**

In a similar vein of Appellant's failure to exercise due diligence in timely objecting to Respondent's derivative claims, Appellant's clear neutrality towards the derivative claims was indicated by its failure to implement the proper procedures and remedies at law for objecting to a derivative claim.

Idaho Code § 30-6-905 provides a clear avenue for an LLC to exercise its business judgment in regards to derivative claims if it wishes to play a role in the litigation. If the LLC timely elects to do so, it must appoint a special litigation committee, investigate the claims, recommend pursuit or dismissal in good faith, and show that the committee selected to investigate the claims was disinterested and independent. I.C. §§ 30-6-905(1)-(5). Source 1 had an affirmative duty to either take an active role in relation to the derivative claims and to decide whether or not to pursue or dismiss the claims to indicate it was not neutral. At no point has Appellant undertaken any of these measures to indicate it was not neutral to Respondent bringing their derivative claims, nor was any action taken by Appellant to indicate non-neutrality until the untimely Motion being filed by Hodge.

The mandate of Idaho Code § 30-6-905 tracks the persuasive logic of many other jurisdictions. It has been found that if a company fails to object to the nature of derivative claims brought on its behalf or to implement the applicable procedures as listed above, neutrality to the derivative claims are presumed. *See Kaplan v. Peat, Marwich, Mitchell & Co.*, 540 A.2d 726, 731 (Del. 1988) ("Because of the inherent nature of the derivative action, a corporation's failure to object to a suit brought on its behalf must be viewed as an approval for the shareholders' capacity to sue derivatively. We hold, therefore, that when a corporation chooses to take a position in regards to a derivative action asserted on its behalf, it must affirmatively object to or support the continuation of the litigation.").

While *Kaplan* is not controlling, the reasoning is extremely persuasive and coalesces with the facts of this case perfectly. Logically, if Appellant wished to object to Respondent bringing a derivative claim on behalf of Source 1, it had the onus of exercising its rights under Idaho Code § 30-6-905 or to responsively plead the failure of demand as an affirmative defense. With no objection indicated from Appellant whatsoever until the eve of trial, Respondent proceeded with litigation and discovery on behalf of Source 1 with the logical presumption that Appellant was neutral to the nature of the derivative claims.

Accordingly, Source 1 is estopped by the silence or acquiescence from objecting to the Plaintiffs' pursuit of derivative claims. *See KTVB, Inc. v. Boise City*, 94 Idaho 279, 281-82, 486 P.2d 992, 994-95 (1971) (citing 31 C.J.S. *Estoppel § 114,* pp. 593-94 ("Where nonaction or passivity is relied on to create an estoppel, it must appear that the party to be estopped was under a duty to act under the circumstances, or, as is sometimes declared, was bound in equity and good conscience actively to evidence his intention not to be bound by the transaction.")).

To allow Appellant to dismiss the derivative claims so late in litigation would dispose of the requirements Idaho Code § 30-6-905, which would only encourage companies in the future to feign neutrality throughout the entire course of litigation on the premise that it can later dismiss substantive claims at the last hour after the movants have exhausted their resources in prosecuting the derivative claims. Such a practice would produce gross waste of the company's resources, the individual's resources in pursuing the claims, and the court's resources. Thus, to prevent such waste, Appellant was required to indicate its non-neutrality to Respondent by following the applicable statutory procedures, or at the very least indicate non-neutrality in a timely dispositive motion or through proper responsive pleadings.

**C. The facts pleaded by Respondent and as proven at trial sufficiently demonstrate that a proper derivative claims has been brought and the demand would have been futile.**

Apart from Appellant's acquiescence to Respondent's derivative claims and the untimely Motion, Respondent has complied with the requirements of bringing a derivative claim. Respondent has pleaded thorough facts and demonstrated at trial that demand would have been

futile, and that Prehn and Bandak had proper standing as a representative class.

In a derivative lawsuit there are three primary requirements for a member or shareholder to maintain such a cause of action: (1) proper standing; (2) compliance with the demand requirement, or demand futility; and (3) fair and adequate representation of the interests of similarly situated shareholders or members. *See* I.C. §§ 30-6-902 — 904; I.R.C.P. 23(f). Each requirement has been met as explained below.

**1) Respondent had proper standing to bring a derivative claim**

The first inquiry in assessing if a derivative claim has been properly made is standing of the member bringing the derivative claim. Proper standing in a derivative action is governed by statute and generally requires that a plaintiff be a shareholder at the time of the challenged transaction and throughout the litigation. *See Taylor v. McNichols,* 149 Idaho 826, 847, 243 P.3d 642, 663 (2010); I.C. § 30-6-903.

Further, the class bringing the derivative claim must be representative of the class of the aggrieved shareholders. I.R.C.P. 23(f) provides the standard for a plaintiff's derivative action standing as follows:

> "The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."

I.R.C.P. 23(f). As a preliminary matter in regards to the pleading standards of a derivative action, factual allegations are to be considered true by the court "unless they are purely conclusory." *Orrock v. Appleton*, 147 Idaho 613, 618, 213 P.3d 398, 403 (2009). There is no requirement that a derivative plaintiff be disinterested and the "disinterested" analysis is only applied to the board of directors, special litigation committee, or the manager of the LLC that would investigate the claims. *Id.* ("The test in a shareholder derivative action is whether the plaintiff alleged particularized facts to creating a reasonable doubt that a majority of the Board would be disinterested or independent in making a decision on a demand.") (internal quotation marks omitted).

Appellant's Brief repeatedly argues that Respondent did not have proper standing to bring

a derivative claim because Prehn and Bandak were not disinterested and there were overlapping factual bases for direct and derivative claims. As stated *supra*, the disinterest of members is only an inquiry that relates to the remaining members or managers in determining if demand upon the company to enforce legal claims would be futile, which in this instance would have been Hodge, Brown and Claiborne.

The thrust of proper standing is a showing that the derivative plaintiff was a member of the LLC at the time the facts of the complaint arose and that he has suffered an injury in fact. I.C. § 30-6-903; *Troutner v. Kempthorne,* 142 Idaho 389, 392, 128 P.3d 926, 929 (2006). As such, Appellant confuses the standard applied to determining standing of a derivative plaintiff. Prehn and Bandak had standing because they were members at the time the facts underlying the complaint arose and they suffered injury in fact that is adequately representative of similarly situated members of Source 1, as was more than sufficiently pleaded in Respondent's First Amended Complaint.

**2) Respondent properly pleaded their derivative claims on behalf of Source 1 and have shown that demand upon Hodge and the majority members would have been futile.**

The district court also properly found that Respondent had properly pleaded their derivative claims on behalf of Source 1 and that demand upon the other members would have been futile.

A member of an LLC may maintain a derivative action if the member makes demand to enforce the rights of an LLC upon the manager of a manager-managed LLC, or if such demand would be futile. *See* I.C. § 30-6-902. The complaint of a member of an LLC must state with particularity the date and content of his or her demand and the response by the manager or other members or, if a demand was not made, the reasons a demand would be futile. *See* I.C. § 30-6-904.

The futility of demand exception is an important component of Idaho's Uniform Limited Liability Company Act that diverges from many of its other entity acts. For example, the Idaho General Corporation's Act does not include a futility exception and this Court has ruled that the

legislature intentionally excluded this exception for corporate shareholders. *See McCann v. McCann*, 138 Idaho 228, 236, 61 P.3d 585, 593 (2002); *see also Mannos v. Moss*, 143 Idaho 927, 934, 155 P.3d 1166, 1173 (2007) (stating "[t]his Court has determined that the legislative intent in enacting Idaho Code § 30-1-742 was to no longer recognize 'futility' as an exception to the requirement of demand as a condition preceding the institution of a shareholder's derivative action") (internal citations omitted). Ordinarily demand would be required only to "afford the directors an opportunity to exercise their reasonable business judgment." *Orrock*, 147 Idaho at 618, 213 P.3d at 403. However, this crucial exception to the Idaho LLC Act expressly allows a member of an LLC to make a showing of why demand would be futile, which includes showing the lack of a director's reasonable business judgment.

Futility may be demonstrated factually in a number of ways. However, there are scenarios in which a demand is presumptively futile. *See, e.g., Ryan v. Old Veteran Mining Co.*, 37 Idaho 625, 218 P. 381 (1923); *In re Ferro Corp.*, 511 F.3d 611 (6th Cir. 2008); *Cathedral Estates, Inc. v. Taft Realty Corp.*, 228 F.2d 85, 88 (2d Cir. 1955) (demand "presumptively futile" where directors and controlling shareholders are "antagonistic, adversely interested, or involved in the transaction attacked"). Heightening this presumption is when there is doubt that the majority of directors could act in a disinterested and independent manner. *See McCall v. Scott*, 239 F.3d 808, 818 (6th Cir. 2001) ("In the context of determining demand futility . . . the issue is whether the particularized factual allegations are sufficient to create doubt about the disinterestedness and independence of a **majority** of the directors.") (emphasis added). Thus, the lack of a reasonable exercise of business judgment of directors as contemplated in *Orrock* would be at play in such a scenario.

This approach to presumptive futility comports well with the case at bar. Here, Respondent's complaint has clearly and specifically alleged facts that prove a demand upon the majority of members to enforce the rights of Source 1 would have been presumptively futile.

Hodge was at all times the sole manager of Source 1. R., p. 760, Ll. 3-5. Prior to the initial Complaint being filed by Respondent, Hodge, Brown and Claiborne, representing a majority of the membership interests, appointed Hodge to liquidate Source 1 notwithstanding

Hodge's statements in writing that he did not intend to process Source 1's existing purchase orders, that he was absolved of any responsibility or duty to Source 1 as an employee or under his non-compete agreement with Source 1, and that he was going to shut down Source 1 within two weeks, all over the objection of Prehn and Bandak.

At the same time, Hodge, Brown and Claiborne's wife formed Source 2, a mirror image company of Source 1, in violation of Hodge's non-compete and court order. After forming Source 2, Hodge was both the liquidator and sole manager of Source 1, and was also the sole managing member of Source 2 as it competed against Source 1 and diverted its business. Def. Exh. 1046, 1049, 1050, 1051, 1052, 1058; Pl. Exh. 2, 27, 31, 57.

Further, Hodge indicated to Prehn that he would be shut out of participation in the dissolution process before the filing of Respondent's derivative claim. Def. Exh. 1046. Antecedent to Respondent's lawsuit being filed, Hodge had also declared that Source 1 would not process voluminous and lucrative purchase orders it received and that he was no longer bound by his non-compete. Complaint ¶¶ 45-46; *see also* Def. Exh. 1049.

Well before the dissolution was complete and before the auction occurred, Hodge and the majority members had already formed Source 2, with Hodge as its sole manager. R., p. 762, Ll. 12-15. While winding down Source 1, Source 2 simultaneously derived over $1,000,000 in sales. R., p. 774, Ll. 12-14. Furthermore, Hodge owed identical fiduciary duties to Source 1 and Source 2 at the time the lawsuit was filed, all while he gave himself an exorbitant salary with Source 1 and a de minimis salary with Source 2. R., p. 771, Ll. 13-20.

The majority members continually profited to the exclusion of both Prehn and Bandak, the minority members. To ask the three majority members to investigate claims that are based entirely on their own conduct would clearly be futile, as not a single member would be disinterested or independent, nor would these actions be deemed the exercise of reasonable business judgment. This lack of disinterestedness not only applies to potential liability of the members for their actions as members of Source 1, but also to their obvious incentive to increase profitability of Source 2 as a competitor to the exclusion of Source 1.

Appellant quotes certain allegations of Respondent's complaint in isolation in an attempt

to contend that Respondent only provided "conclusory statement[s] in each of the derivative claims." Appellant's Brief, p. 25. This assertion ignores the litany of factual allegations Respondent pleaded throughout the complaint (as listed above) that indicate demand would have been futile and that the actions taken by Hodge were not the valid exercise of his business judgment, all of which were incorporated by reference in each claim for relief. These facts were pleaded with particularity in Respondent's complaint in fulfillment of applicable Idaho law and rules. Even if demand was not presumptively futile, or if presumptive futility is not considered, the specific facts of this case as pleaded by Respondent indicate that in this instance, demand upon the majority members would have been futile.

Appellant then points to actions Hodge deems to have been proper, none of which are material to Respondent's derivative claims. For example, Appellant opines that Respondent was eventually afforded participation in the liquidation auction. However, Respondent's claim is that Appellant breached the terms of the district court's order and that Hodge breached his duty to minimize costs at auction and was deceitful in the bidding process, not the purported "participation" of Respondents in setting up the auction.

Finally, Appellant claims that Prehn's only motive to bring this suit was to recover upon his personal loan and back-salary. It should first be noted that Prehn's direct claims should have not been necessary, as Hodge violated the operating agreement of Source 1 by initiating excessive distributions upon dissolution instead of first paying Prehn as a creditor of Source 1. Def. Exh. 1043.

Moreover, this argument ignores the fact that members aside from Prehn stood to recover from a derivative claim, as others had positive capital accounts at dissolution and were entitled to distributions in relation to their capital accounts. Pl. Exh. 102. Bandak was also clearly a member of the aggrieved class with a positive capital account and not only did he stand to recover as pleaded by Respondent, but actually will stand to recover damages and attorney fees awarded by the district court to Source 1 in accord with his capital account. R., p. 1105-06.

As the foregoing shows, the reasons why demand would be futile have been thoroughly pleaded and the district court ruled correctly in finding that demand would have been futile in this

instance as pleaded by Respondent.

**3) Prehn and Bandak clearly represented a fair and adequate representation of the interests of similarly situated members and were in fact the entire class of similarly situated individuals as the minority membership interest.**

Appellant attempts to blur the distinction between proper standing of a derivative plaintiff and the requirement that the derivative plaintiff should be an adequate representative of similarly aggrieved members. While there is some inherent overlap in these two requirements in bringing a derivative claim, Respondent will address this third requirement separately.

As stated *supra*, Appellant erroneously contends that a derivative plaintiff must be disinterested. If Appellant's argument is accepted, it would in effect preclude virtually all derivative suits from proceeding:

> [Federal Rule 23.11 provides that plaintiff must adequately represent "shareholders or members who are similarly situated...." However, Rule 23.1 also requires that the shareholder be enforcing a right of the corporation that it refuses to enforce, a decision typically arrived at through a vote of its stockholders. Applied literally, these two provisions appear contradictory: plaintiff is supposed to represent the shareholders but the objective of the litigation coincides with the desire of only a minority and is contrary to the will of the rest of the stockholders.
>
> **Obviously, if this type of antagonism were treated as demonstrating inadequacy of representation, it could result in the dismissal of virtually all derivative suits. Thus, the second sentence of Rule 23.1(a) must be read as only requiring plaintiff to be an adequate representative for those "similarly situated" shareholders—namely, the minority stockholders."**

7C WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE 2D § 1833 (2007) (emphasis added).

Here, both Prehn and Bandak's interests align perfectly, as they both represent the aggrieved minority membership in its entirety. The separate direct claims of Prehn are not at all antagonistic to Bandak's interests and both proceeded in unison to protect minority member rights through a derivative claim on behalf of Source 1. Both were members at the time of dissolution, both had coupled interests in minimizing expenses and maximizing distributions at dissolution, both were the only members without a pecuniary interest in developing competitor Source 2, and both suffered harm due to Hodge's conduct at the dissolution auction.

Resultantly, Respondent could not have included any other member as a derivative plaintiff because although the remaining members were affected by Hodge's action as members of Source 1, none would have taken action to impartially investigate the claims due to their pecuniary interests in Source 2. In other words, none of Hodge, Brown, or Claiborne were similarly situated to Prehn and Bandak as to the damages contained in Respondent's derivative claims. As such, Respondent represented the proper derivate plaintiff class.

Appellant also has suggested that because Prehn has brought direct claims and there is some factual and chronological overlap, he is barred from also pursuing a derivative claim on behalf of Source 1. *See* R., pp. 543-45; *see also* Appellant's Brief, p. 22. Idaho case law concretely disaffirms this contention. *See McCann,* 152 Idaho at 817, 275 P.3d at 832 (holding that derivative and individual actions may both grow out of the same wrong). Furthermore, the applicable statutory provisions explicitly provide for both a direct claim and a derivative claim, which are not mutually exclusive anywhere in the code. *See* I.C. §§ 30-6-901 — 902.

As a general principle, it is well known that shareholders have the right to bring direct and derivative actions at the same time. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964); *Moffatt Enter., Inc. v. Borden Inc.*, 807 F.2d 1169, 1176 (3d Cir. 1986); *Yamamoto v. Omiya*, 564 F.2d 1319, 1326 (9th Cir. 1977); *see also* 19 Am. Jur. 2D *Corporations §* 1934 ("a shareholder may bring a derivative action and an individual claim at the same time if he or she has suffered a different injury than the other shareholders"). A "conflict" that exists in cases where a plaintiff brings both derivative and direct claims is usually theoretical in nature. *See First Am. Bank & Trust by Levitt v. Frogel*, 726 F. Supp. 1292, 1298 (S.D. Fla. 1988); *In re TransOcean Tender Offer Sec. Litig.*, 455 F. Supp. 999, 1014 (N.D. Ill. 1978). Unless an actual conflict arises that effects a shareholder's ability to effectively prosecute a derivative claim on behalf of the company, the direct and derivative claims may both proceed. *Natomas Gardens Inv. Grp., LLC v. Sinadinos*, 2009 WL 1363382 (E.D. Cal. 2009).

In examining the causes of action as pled by Respondent, it is clear that the nature of his claims for his back-salary and unpaid loan are distinct and separate from the claims related to harm suffered by both Prehn and Bandak in their derivative claims. The direct claims arose well

before dissolution and are not related to the derivative claims, which arose from Hodge's dishonesty and misconduct during the dissolution process and at auction.

As one example, Respondent's claim for unjust enrichment against Source 2 is in no way personal, as the judgment awarded for this claim was properly to Source 1 as a company, not just to Prehn and Bandak personally. R., p. 780, Ll. 11-13; p. 1105, ¶¶ 1-2. Further, Hodge had a duty pursuant to the Source 1 operating agreement to both Source 1 and all its members to not engage in disabling conduct and his liability for breaching this provision was to Source 1. *See* Pl. Exh. 1, Operating Agreement at p. 8, § 6.6. For the successful derivative actions, damages were awarded to Source 1 and its members for this breach, not only Prehn.

Appellant also argues that Respondent only pursued this lawsuit for the repayment of his personal loan and back-salary from Source 1, and that the derivative action did not benefit all members of Source 1. This contention ignores that Respondent successfully brought numerous derivative claims in which Source 1 and its aggrieved members recovered substantial damages and attorney fees from Hodge and Source 2 in amounts that exceed Prehn's direct claims. Source 1 and all members of the aggrieved class clearly stood to benefit from Respondent's successful derivative claims, not just Prehn.

Further, the derivative claims cannot logically stand to benefit a member who purposefully initiated the harm to the company or else a derivative claim would only encourage further bad acts. The purpose of a derivative claim is to bring an action on behalf of the company to protect its aggrieved members of the company, not reward bad actors. Appellant's argument on this point falls flat and is contrary to the policy of a derivative claim.

In sum, Appellant has only averred theoretical conflicts of Prehn's individual direct claims that never came to fruition. No such conflict ever arose, as was later evinced by the successful derivative claims in which Source 1 obtained the relief it sought. Thus, the district court ruled correctly in identifying the distinct nature of the derivative and direct claims, and ruled in favor of Respondent accordingly.

**4) The district court properly ruled that Respondent did not create an inherent conflict of interest by failing to hire an independent attorney to**

**represent Source 1 in the pursuit of its derivative claims**

At the final hour, Appellant attempts to decry the Respondent using the same attorneys for the direct and derivative claims. From the outset Appellant knew that Respondent was using the same counsel for both claims, yet it has made no motion to disqualify Respondent's counsel. Instead, Appellant elected to wait until the eve of trial to contest the representation in an attempt to prevail on substantive grounds to dismiss the derivative claims.

A conflict of interest exists if "the representation of one client will be directly adverse to another client" or if there is a significant risk that the representation of one client will be materially limited by the lawyer's responsibilities to another client. IDAHO R. OF PROF'L. COND. 1.7(a). Whether clients are aligned directly against each other requires examination of the context of the proceeding. *Id.* at cmt. 17. The context of this proceeding clearly indicates that previous counsel's representation was appropriate.

First and foremost, Idaho case law is clear that motions to disqualify counsel should be brought at the beginning of litigation and the movant of such motion must act with "promptness and reasonable diligence **once the facts upon which the motion is based have become known**." *Crown v. Hawkins Co., Ltd.*, 128 Idaho 114, 123, 910 P.2d 786, 795 (Ct. App. 1996) (emphasis added); *see also Weaver v. Millard*, 120 Idaho 692, 698, 819 P.2d 110, 116 (Ct. App. 1991) (denying a motion to disqualify counsel after discovery was well underway and dispositive motions were pending due to the prejudice in disqualifying counsel so far into litigation). Accordingly, a failure to act promptly may warrant denial of an untimely motion to disqualify counsel. *Id.*

Here, Appellant did not only fail to timely bring a motion to disqualify counsel, he failed to bring any motion to disqualify at all. Much like Appellant's Motion to Dismiss Derivative Claims, the argument was proffered at the last minute after initiating intensive discovery, trial preparation, and other pleadings. To disqualify counsel at the point Appellant first argued there was a conflict of interest would have been extremely prejudicial to Respondent, especially when considering that the facts that formed Appellant's complaint existed from the onset of litigation and a disqualification of counsel could have been argued early on if Appellant had exercised any

modicum of diligence or promptness.

Timeliness and failure to bring a proper motion to disqualify aside, previous counsel (hereinafter "Moffatt Thomas") represented the interests of the aggrieved membership and had no attorney-client relationship with Source 1. Source 1 retained Judy Geier to represent its interests. To wit, Source 1 never elected to stay proceedings to investigate or otherwise timely exercise its rights to contest the derivative claims under Idaho Code § 30-6-905. At no point did Moffatt Thomas contact Source 1 except through appointed counsel.

Appellant relies exclusively upon Judge Elgee's Order for the proposition that the Plaintiffs must retain new "truly independent counsel" to pursue the derivative claims. Order on Defendants' Motion to Dismiss, *Vorse v. D&R Real Estate,* Case No. CV-2010-763 (March 14, 2015) (Idaho 5th Dist). Although there exist many distinctions between the *Vorse* case and the instant case, the **absolutely critical distinction** is that the LLC in question, Hourglass Development, LLC, took an active role related to the derivative claims, timely objected to such claims, and timely filed a motion to dismiss, challenging the adequacy of the plaintiff to prosecute the derivative claims. In other words, Hourglass determined that the claims should be dismissed, based on its business judgment, or pursued independently on its own account and in its own name as Appellant should have done in this instance if it objected to the derivative claims.

No such determination was ever made by Source 1. Source 1, who was represented by separate counsel, elected not to take an active role in the derivative claims and displayed ongoing neutrality to the claims. Source 1 thus abandoned any right to exercise any business judgment or control over the derivative claims, which permitted Respondents to proceed with its counsel on both claims and no conflict existed that would materially limit counsel's representation to another client.

Appellant further argues that somehow discovery requests were groundless due to "having complete access to the record and books" and that this shows a conflict. Appellant's Brief, p. 28. This contention is without merit and is firmly rebutted by the record. Throughout litigation, Respondent was required to file motions to compel to combat the dilatory and manipulative tactics of Appellant, as evidenced by Respondent's successful motions to compel. R., p. 527.

Appellant failed to timely object to the representation of Respondent and failed to use the proper vehicle to state such objection, which would have been through a motion to disqualify when the potential conflict became apparent to Appellant. If any potential conflict existed, it should have been apparent at the outset of the case when Respondent brought both derivative and direct claims through his counsel, not after intensive discovery and at the eve of trial. It appears Appellant elected to stay mum on any potential conflicts of representation throughout the bulk of litigation in the hopes to win substantively near trial. Appellant may not attempt to now object to representation in an effort to prevail on substantive grounds.

In addition to not identifying any potential conflict that might have precluded Moffat Thomas' representation for the derivative and direct claims, Appellant has not identified any actual conflict that arose. Appellant has not been prejudiced in any way by Respondent's representation and no actual conflict arose in representation. Again, Respondent successfully prosecuted the derivative claims to the benefit of Source 1 and any complaint Appellant has at this point would be an ethics claim, not a dispositive motion to dismiss derivative claims.

In accord with the above arguments, Respondent respectfully requests that this Court affirm the district court's ruling that Appellant's dispositive Motion was untimely, that demand by Respondent was not required because it would have been futile, that Respondents properly pleaded derivative actions and that the facts demonstrated futility, and that there was no conflict of interest for Respondent's prior counsel that would have materially limited the representation of another current client and cause the derivative claims to be dismissed.

## III. The district court ruled correctly in finding that Hodge breached his fiduciary duties to Source 1 and its members in the orchestration of the auction and in failing to minimize the costs of completing purchase orders per the Source 1 operating agreement, the district court's Order RE: Dissolution and applicable Idaho law.

The Respondent presented credible and persuasive evidence at trial that as a matter of law, Hodge breached his fiduciary duty to Source 1 and its members via the manner he orchestrated the auction and in its dissolution. Hodge orchestrated the auction as the sole manager and liquidator for Source 1 while concurrently operating and solely managing an identical company in

Source 2. In fulfillment of the obvious likelihood for conflicts of interest of this relationship that Respondent feared, Hodge succeeded in maximizing the value gained at auction for himself and Source 2, and in inflating Source 1's costs to the benefit of Source 2, leaving no remaining cash for Source 1 and its remaining minority members.

This manipulation at auction was achieved through a series of dishonest tactics leading up to and after auction. The manner in which Appellant bifurcated the lots to be auctioned was clearly misleading, as were many of the estimated values attached thereto. Appellant attempts to direct all focus on aspects of the auction that were agreed to or otherwise not objected to by Respondent, yet fails to address that the auction was conducted in a manner that violated the district court's dissolution order and his legal obligations to Source 1. Hodge proceeded to breach his fiduciary duties owed to Source 1 and its members despite feigned attempts at showing equal participation after he was caught trying to rig the bidding process.

Furthermore, extensive and credible evidence was presented that Source 1 incurred substantial losses in profit due to Hodge's failure to minimize costs in processing purchase orders and winding the company down. Respondent presented a cogent history of Source 1's profit margins and expenses to the district court and was able to show with reasonable certainty the losses incurred from Hodge's misconduct in completing existing purchase orders.

Despite assurances from Appellant that general and administrative expenses would be minor in processing the existing purchase orders while winding down, these expenses were in fact grossly high and resulted in Source 1 and its members receiving zero financial return. As such, the district court properly ruled that Hodge breached his fiduciary duty to Source 1 and its members per the Source 1 operating agreement and applicable Idaho law in failing to minimize costs in winding down and in his orchestration of the dissolution auction.

### A. Hodge breached his fiduciary duty to Source 1 and its members in misleading Respondent as to what would be included in the auction lots to be bid upon.

To make a claim for breach of fiduciary duty in this context, it must be shown by the plaintiff that defendant owed the plaintiff a fiduciary duty and that the duty was breached. *Mitchell v. Barendregt*, 120 Idaho 837, 820 P.2d 707 (1991). As a fiduciary, a manager is "bound

to exercise the utmost good faith" in managing the company. *Steelman v. Mallory,* 110 Idaho 510, 513, 716 P.2d 1282, 1285 (1986). Idaho Code affirmatively states that a manager of a member-managed limited liability company owes the company and its members the fiduciary duties of loyalty and care, and more specifically the duties enumerated below:

> (a) To account to the company and to hold as trustee for it any property, profit or benefit derived by the [manager];
> (i) In the conduct or winding up of the company's activities;
> (ii) From a use by the [manager] of the company's property; or
> (iii) From the appropriation of a limited liability company opportunity;
> (b) To refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and
> (c) To refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.

I.C. § 30-6-409(2). The manager owes the following duty of care and loyalty as follows:

> "Subject to the business judgment rule, the duty of care of a [manager] in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member *reasonably believes to be in the best interest of the company.*"

I.C. § 30-6-409(3) (emphasis added); *see also* Pl. Exh. 1, Operating Agreement at p. 8, § 6.6 ("In carrying out his duties and exercising his powers hereunder, the Manager shall exercise reasonable skill, care and business judgment."). Clearly, Hodge owed Source 1 and its members certain fiduciary duties as both the manager and as the liquidator of Source 1.

The first breach of Hodge's fiduciary duty in the orchestration of the auction was his description of the lots to be sold at the auction, namely in manipulating the descriptions of the shaker cup molds and the intellectual property. As liquidator, Hodge divided the assets of Source 1 into five separate lots: 1) Shaker cup molds; 2) Embroidery machines; 3) Office inventory; 4) Intellectual property; and 5) All lots.

There was substantial dispute that arose over the method of auction proposed by Hodge. Hodge wished to initially receive all other bids and then make his own final bid, but upon continued objections by Prehn he implemented a "blind bid" process in which he would have the final bid, but would not see the last bids preceding his. Obviously Prehn objected to the original

proposal because Hodge could simply see the bids and make his slightly higher, thus enabling him to win whichever bid he desired.

The process was then altered and Hodge sent out brief descriptions of what each lot would contain and the estimated value attached thereto. Prehn did not challenge or supplement the descriptions at this time because it appeared clear what each lot would contain.

Nonetheless, Appellant's emphasis on these changes to the auction structure are misguided and frankly irrelevant. Although Hodge's initial proposal of conducting the auction indicated his intention to fix the auction from the onset, the true breach of fiduciary duty was committed in the misleading description of the lots and in the actual orchestration of the auction and the actions taken thereafter, not necessarily in the preliminary planning stages.

In advance of the auction, brief descriptions of the lots were provided to the members of Source 1 in an e-mail from Hodge. R., p. 140, ¶ 61. In relevant part, the description for the intellectual property was as follows:

> "This will consist of all good will in the company as well as all non-tangible property of The Source Store, LLC. This will include all Names, Logo's, concepts, artwork, Product names, Website, Facebook, Race concept."

*Id.* In the same e-mail, Hodge described the shaker cup lot to contain "all 5 of the molds that are use [sic] at Technology Plastics to complete the 'Patriot Shaker.'" Pl. Exh. 72.

On May 18, 2012, the auction was held. Upon completion of the auction, Hodge won the bids on the intellectual property and embroidery machines at $44,200.00 and $10,010.00 respectively. Prehn was the high bidder on the shaker cup molds and office inventory at $96,000.00 and $15,100.00 respectively. The difference in bid amounts on shaker cup molds and intellectual property were stark. Hodge's bid on the shaker cup molds was at $40,200.00, whereas Prehn's was $96,000.00. R., p. 713. As stated *supra*, the mold's scrap value without the ability to produce the cups was determined to be $1,900.00.

The difference in bids for intellectual property were remarkably juxtaposed as well, as Prehn's final bid was $5,000.00 and Hodge final bid was $44,200.00. R., p. 779, ¶ 14. Hodge procured Prehn's low bid by initially placing his first two bids on the intellectual property for

$5,000.00 each and then jacking his final bid up to $44,200.00. TR., p. 344, Ll. 1-11.

Only after winning the bid for the intellectual property did Hodge proclaim that he had the exclusive right to produce the cups through the intellectual property bid. Pl. Exh. 71. Hodge's counsel then asserted to Technology Plastics, the manufacturer of the shaker cups, that they were prohibited from using the molds to manufacture the cups for Prehn because doing so would violate the intellectual property won by Hodge. Pl. Exh. 73. Thus, assuming Hodge's assertion regarding his intellectual property rights was correct, Prehn paid $96,000.00 for an item worth $1,900.00 in scrap value. Because the shaker cup molds were essentially valueless, Prehn declined to pay this amount when invoiced for the bid and placed the funds with his counsel in trust. Hodge responded by declaring himself the winner of all bids as the second highest bidder.

At no point did Hodge explain to the members of Source 1 that the intellectual property lot included the exclusive right to produce the shaker cups using the molds, nor was this information contained in the description of the lot sent to Source 1 members despite other highly specific items being in the description (i.e. "Race Concept"). Further, evidence was admitted to the record showing that Hodge represented via numerous e-mails that the intellectual property would only be for minor items. *See* Pl. Exh. 66, 67, 71; TR., p. 344, Ll. 6-11. Only after the auction was concluded did Hodge's counsel indicate that he believed the intellectual property precluded Prehn from using the shaker cup molds for production purposes. Pl. Exh. 71.

Resultantly, Prehn was not willing to pay $96,000.00 for a valueless item. Hodge then declared himself the high bidder for all lots at cost of $105,010.00, whereas Source 1 would have received $165,310.00 if Prehn's bids had prevailed. These actions taken by Hodge at the auction ultimately cost Source 1 $60,300.00. R., p. 779.

Therefore, the district court properly concluded that Hodge breached his fiduciary duty to Source 1 by providing deceptive descriptions of the lots to be auctioned and thereafter rendering Prehn's bid worthless. The manipulation of the auction was a clear breach of Hodge's fiduciary duties as the manager of Source 1 and the evidence on record clearly supports the district court's finding that these acts damaged Source 1 and its members.

Appellant also argues that by the dismissal of Claims 14 through 19 of Plaintiff's Second

Amended Complaint, Respondent somehow waived damage claims stemming from the auction. As the district court concluded, this contention falls flat. The deceptive acts of Hodge at auction were clearly addressed in the remaining claims of the Second Amended Complaint and such acts clearly form the bases for Respondent's breach of fiduciary duty claim, in addition to his breach of contract and breach of good faith and fair dealing claims.

Respondent voluntarily stipulated to dismissing the aforementioned claims due to judicial efficiency. Respondent's remaining causes of action properly addressed the wrongs committed by Appellant and pursuing the remainder of the claims eventually dismissed was no longer necessary.

Finally, Appellant peculiarly alludes to the fact that Prehn had contacted BodyBuilding.com for a potential business venture regarding shaker cups. First, it should be noted that this contact occurred after the agreed upon expiration of Prehn's non-compete and after the auction. More importantly, this averment has no relation whatsoever to Hodge's deceit at auction and has no relation to the district court's finding on Hodge's numerous breaches at auction.

Due to the foregoing, Respondent therefore requests that this Court uphold the district court's conclusion that Hodge's breach of fiduciary duty in orchestrating the auction caused damages to Source 1 and its members as awarded.

**B. Hodge breached his fiduciary duty to Source 1 and its members in failing to minimize costs of completing the Source 1 purchase orders upon the winding up of the company.**

Appellant's sole contention upon appeal is that the district court's finding of fact regarding the standard for calculating damages in the winding up of Source 1 was clearly erroneous. Respondent has demonstrated substantial and credible evidence that profit margins should have been drastically higher upon final dissolution of Source 1 and the fact that Prehn's testimony conflicts with that of Appellant's expert should not disturb the district court's finding of fact on appeal. *See Hull v. Giesler*, 156 Idaho 765, 772, 331 P.3d 507, 514 (2014).

The court properly elicited the standard for damages in a breach of fiduciary duty context,

which is the breach of trust. *See Steelman*, 110 Idaho at 514, 716 P.2d at 1286 (1986). The damage calculation to be applied from this rule is a loss of profits standard, as the fiduciary who breached his duty should be liable for the loss of profit stemming from his breach. *Pickering v. El Jay Equip. Co., Inc.*, 108 Idaho 512, 517, 700 P.2d 134, 139 (Ct. App. 1985). In *Steelman*, the Court found that the measure of damages from the breach of fiduciary duty is "for any profit which they [breaching party] received as the result of their breach and which would have accrued to the corporation had they not breached their fiduciary duties." *Steelman*, 110 Idaho at 514, 716 P.2d at 1286 (1986).

In this case, extensive evidence was presented that Hodge's breach lead to a loss of profits that would have accrued to Source 1 but for Hodge's breach of fiduciary duty in failing to minimize costs in winding up. Source 1 became a profitable company beginning in fiscal year 2010 and remained consistently profitable up until dissolution, with costs remaining consistent relative to sales. R., p. 772, Ll. 5-24; p. 773, Ll. 1-7. Prior to dissolution in April of 2012, Hodge had represented to Source 1 members that the costs of winding up should be markedly lower than other periods because the orders were almost complete and overhead would be limited. Contrarily, the general and administrative costs skyrocketed during dissolution, causing a net operating loss for the dissolution period. R., p. 773, Ll. 8-19; p. 774, Ll. 1-2.

At the time it was decided that Source 1 was to be dissolved, Hodge had a negative capital account and due to his position financially with the company, coupled with his concurrent ownership and financial incentive of Source 2, Hodge knew early on that an efficient winding down of Source 1 would not be to his benefit.

Prior to the stipulated Order RE: Dissolution, Source 1 received a purchase from BodyBuilding.com worth $233,481.84, which he refused to fill through Source 1. *See* R., p. 768, ¶ 26. Approximately two months later, Hodge filled this purchase order through Source 2 and therefore took a lucrative deal from the Source 1 for his own personal benefit. *Id.*

While a number of Source 1 costs in dissolution remained similar to the company as a going concern, the "glaring anomaly," as described by the district court, was the difference between general and administrative costs. *Id.* The general and administrative costs in 2010, 2011

and 2012 up until dissolution were between 24.24% and 27.61%, whereas the number skyrocketed to 43.03% during the nine month dissolution period. *Id.*

Couched into "general and administrative expenses" for the dissolution period was a $97,386 salary paid to Hodge (in contrast to $6,000 salary paid to Hodge by Source 2 for that same period), compensation for a time in which Hodge was simultaneously developing his competing company Source 2 on Source 1's dime. Hodge developed over $1,000,000 in sales during this period for Source 2 while compensating himself a nearly six-figure salary from Source 1. Per the operating agreement of Source 1, Hodge was only entitled to reasonable compensation as liquidator if he performed more than de minimis services. Pl. Exh. 1, Operating Agreement at p. 23, § 14.2. Appellant has offered no rebuttal as to how this salary was reasonable, likely in light of the fact that he was using the majority of his time to develop Source 2 while using Source 1 resources, and contributing very few services to Source 1 in his role as liquidator.

Further, Appellant drove up the rent substantially for Source 1 during the period of dissolution. The average monthly rent between 2010 and 2012 leading up to dissolution remained between $2,013 and $3,018. R., p. 774, Ll. 15-17; p. 775, Ll. 1-8. This figure nearly doubled during the dissolution period at an average of $5,841 per month in the months that Source 1 reported paying rent. *Id.* To make this expense even more unreasonable is the fact that Source 2 was operating out of the same rental unit as Source 1 at this time and charging the entire rent to Source 1, which also has not been explained by Appellant.

During the dissolution period, Hodge also retained highly compensated Source 1 employees that were unnecessary to dissolution while they primarily worked for Source 2, attributed discounts on materials to Source 2 and allocated the difference to Source 1 to raise their expenses, and used the same suppliers and products. Not surprisingly, Appellant has been unable to explain how these costs were reasonable.

Appellant's contention that the district court placed the burden of proof upon Hodge to rebut the calculation of damages is misguided. The record clearly shows that Respondent offered extensive evidentiary support that Hodge breached his fiduciary duty as both manager and liquidator of Source 1 by artificially driving up the costs of Source 1 in numerous ways, including

but not limited to Hodge's exorbitant salary, high rental charges, the improper use of Source 1 resources and keeping expensive staff longer than necessary to increase Source 1's payroll, thereby subsidizing Source 2's payroll at the cost of Source 1. R., pp. 772-75.

Appellant does correctly state that loss of profits must simply be proven to a degree of reasonable certainty and not be overly speculative. *See Clark v. International Harvester Co.*, 99 Idaho 326, 346-47, 581 P.2d 784, 804-05 (1978). Aside from the fact that considerable business records indicated consistent profit margins for a bases of comparison, Respondent showed to a reasonable degree of certainty loss of profits due to the failure of Appellant to minimize expenses and the district court's decision reflects that Respondent met his burden. The fiduciary duty to minimize costs at auction was for the purpose of maximizing member distributions, and minimizing costs to maximize profit was quintessential in achieving such return. *See* R., pp. 123-24, ¶ 4 (pursuant to the Dissolution, the overhead and other expenses of Source 1 be reduced to the absolute minimum necessary to complete the Dissolution, including without limitation the processing of the existing purchase orders and the sale of the Assets, **in order to maximize the return and final distribution of funds to all Source 1 members**") (emphasis added).

On appeal, Appellant tries again to advance its argument that the profits of Source 1 prior to dissolution as a going concern should not have been considered. At trial, Appellant relied on its expert witness Peter Butler to support this argument, who gave his general opinion as to the difference in valuing a business as a going concern versus during dissolution. As argued previously by Respondent and as found by the district court, Mr. Butler simply tried to poke holes in Prehn's analysis of damage calculations and did not address the actual expenses incurred by Source 1 in the dissolution process, nor if such expenses were actually reasonable. R., p. 775, Ll. 9-15.

Mr. Butler presented general academic principles of business valuation methods of a business as a going concern versus a company during dissolution, but failed to address the size and nature of Source 1 and the specific circumstances of the facts at bar, namely that Hodge operated competitor Source 2 as a going concern that would offer a disincentive to achieve any real efficiencies of operation for Source 1. *Id.* Further, he admittedly did not analyze if the

expenses incurred by Appellant for Source 1 were reasonable. TR., p. 759, Ll. 2-4.

The unique fact that Hodge operated Source 2 as a going concern while dissolving Source 1 is of enormous consequence to analyzing the proper measure of loss of profits in this case. The record shows that Hodge used and misappropriated resources of Source 1 in running Source 2. This overlap includes Source 1 not firing employees and using them for the benefit of Source 2, Source 2 occupying and using the same space as Source 1, using the same suppliers and products, and raising costs of Source 1 in return for discounts on the same materials for Source 2.

Due to these specific facts, Source 1 was in all reality operating as a going concern due to operating Source 2 through identical resources. As such, the efficiencies of Source 1 should have logically tracked its business records leading up to dissolution because it was still operating in the same fashion, albeit that Source 2 was diverting its resources simultaneously. Mr. Butler was not aware of any of these facts in giving his testimony and made general conclusions regarding valuation methods.

Moreover, Mr. Butler did not appear to appreciate the nature of the "fixed and variable" costs associated with businesses like Source 1. Source 1 is a "drop ship company" which means that a majority of the company's expenses are related to acquiring the order from the customer and then setting up the order with a third party factory, which leads to low overhead costs. Mr. Butler did not appear to have knowledge of Hodge's low projected expenses given to the board, nor did he realize that Hodge used Source 2 to operate as a going concern of Source 1 during dissolution. Finally, Mr. Butler was not aware that Hodge had a negative capital account with Source 1 and stood no benefit in maximizing member returns.

Nowhere in Mr. Butler's opinion did he address the actual facts at hand and as such, his general narrative on valuation methods was not helpful in determining the damages caused by Hodge's failure to minimize the costs of dissolution. Appellant's attempt to attack Prehn's financial accreditations ignores the fact that the only credible testimony regarding damages actually incurred was Prehn's due to his actual and intimate knowledge of the facts leading to the damages from Hodge's breach. In sum, Butler did not have the facts necessary to assess whether Hodge purposely mismanaged Source 1 during dissolution.

In opposition to Appellant's calculation of damages, Respondent demonstrated consistent and accurate profit margins leading up to dissolution, and demonstrated the gross irregularities during the dissolution period. Additionally, as described *supra*, Respondent provided voluminous evidence that the costs incurred by Hodge during dissolution were patently unreasonable.

Furthermore, the district court acknowledged that there were certain increased legal and accounting costs related to the dissolution and deducted these costs from the damages, which were the only increased expenses that Appellant could explain. R., p. 776, Ll. 17-18. Thus, the district court did acknowledge that some of the general and administrative costs were reasonable and deducted those costs from the award of damages, but found that the vast majority of expenses were not reasonable in light of the facts presented.

As the record indicates, the district court's finding of fact was not clearly erroneous, as it properly weighed the substantial evidence presented by both parties and decided that lost profits was the proper measure of damages given the facts of this case. As such, Respondent requests that the Court not disturb the district court's sound finding of fact.

## IV. The district court ruled correctly in finding that Respondent is entitled to attorney fees pursuant to Idaho Code § 12-120(3) for the derivative action against Hodge in favor of Source 1.

An award of attorney fees may only be set aside if the Court finds that the district court's award was an abuse of discretion. *Bailey v. Sanford*, 139 Idaho at 753, 86 P.3d at 467. Idaho appellate courts have held that an award of attorney fees is mandatory in cases arising out of a commercial transaction. *See Freiburger v. J U B Engineers, Inc.,* 141 Idaho 415, 423, 111 P.3d 100, 108 (2005) ("Where a party alleges the existence of a contractual relationship within a commercial transaction, that claim triggers the application of the statute allowing attorney fees for the party which prevails on a civil claim involving a commercial transaction."); *see also Lamprecht v. Jordan, LLC,* 139 Idaho 182, 75 P.3d 743 (Ct. App. 2003) ("A prevailing party in a civil action involving a commercial transaction has a statutory right to an award of reasonable legal fees."). To award attorney fees under Idaho Code § 12-120(3), the commercial transaction must be integral to the claim and must provide the basis for recovery. *See Iron Eagle*

*Development, LLC v. Quality Design Systems, Inc.*, 138 Idaho 487, 65 P.3d 509 (2003).

Appellant expresses much consternation that attorney fees were awarded to Respondent pursuant to Idaho Code § 12-120(3) by primarily reiterating his stance that Respondent failed to bring a proper derivative claim. Again, Appellant advances the argument that Prehn's direct claims grossly outweighed damages to be obtained in the derivative claims despite the fact that the derivative claims were substantial and such damages were awarded to Source 1 for both Bandak and Prehn. In fact, the recovery sought and ultimately obtained on the derivative claims exceeded those of Prehn's direct claims.

To the extent that Appellant argues that the derivative and direct damages awarded were fairly similar in dollar amounts, the dollar amounts ultimately awarded have no bearing on the nature of the claims. Even if one considers the derivative damages for Source 1 and the direct damages of Prehn similar, it has no bearing on the fact that they were easily distinguishable in nature, as there were numerous, separate transactions giving rise to Respondent's claims.

The crux of Appellant's argument is that attorney fees would be precluded because it considers Respondent's claim to all be "personal" as defined in Idaho Code § 12-120(3) instead of derivative. Respondent will not reiterate all arguments stated above that indicate the derivative claims were proper, except to rebut that Appellant's reasserted claim that the district court did not consider the Motion to Dismiss Derivative Claims is false and that the district court clearly considered the motion on its merits.

Appellant opines that any recovery on the derivative claims will only stand to benefit Prehn and not any other member. *See* Appellant's Brief, p. 41 ("The only member entitled to the judgment amount awarded to Source 1 in the alleged derivative action was Prehn."). This argument is patently false for a number of reasons.

First, as stated *supra*, the damages awarded to Source 1 actually exceed the amounts owed to Prehn for his back-salary and loan. *See* R., p. 1105, ¶¶ 1-5. Though Prehn has first priority as a creditor of Source 1, there remains excess damages that will be distributed to other members after Prehn is paid back for his back-salary and loan.

Second, Source 1 was awarded certain attorney fees and costs that were to be paid by

Hodge directly to Source 1. These amounts are then to be paid to Prehn and Bandak, who shared the cost of litigation. As such, it is clear that Prehn was not the only derivative plaintiff to suffer an injury in fact and in turn receive damages from the award. Simply because Prehn had a priority to any judgment does not mean that other members did not stand to benefit from the derivative claims. The measure of damages sought and ultimately obtained at trial was more than sufficient to also compensate the other aggrieved members of Source 1 for Hodge's numerous breaches.

This argument also neglects to consider that upon the vote to liquidate, there were plenty of funds to pay off Prehn as a creditor before making member distributions. Prehn warned Hodge in the days following the vote for dissolution that no member distributions should be made before paying back Prehn's loan and back-salary. Hodge then refused and made the member distributions anyway. If Hodge had not made such distributions during dissolution in violation of the Source 1 operating agreement, Prehn would have been paid off and the members would have received final distributions from the auction and from profits of processing the remaining purchase orders (assuming costs would have been properly minimized). Def. Exh. 1043, 1053. Thus, to categorize Respondent's claims as purely "personal" is erroneous and does not align with this case as pleaded, nor does it comport with the actual results of the litigation.

Appellant emphasizes the quote from Respondent's previous counsel that this "was not a true derivative claim." This quote in isolation does not properly put the statement made by Respondent's counsel in context, which was proposed to suggest that this case carried both direct and derivative claims. Also, this case would not benefit all members, as certain members who were bad actors would not and should not stand to benefit from the derivative claim. More accurately stated, this case is not only a derivative claim, but involves direct and derivative claims that were properly bifurcated and pursued by Respondent.

Further, the derivative claims were substantially grounded in a commercial transaction and the district court correctly found that the availability of attorney fees under Idaho Code § 30-6-906(2) does not preclude Respondent's recovery of attorney fees under Idaho Code § 12-120(3). Aside from the derivative claims being grounded in commercial transactions, the harm to be redressed would be more properly awarded by attorney fees under Idaho Code § 12-120(3) if

the Court would find that the recovery of such fees would come out of the recovery of Source 1 against Hodge, as Hodge's bad acts would be rewarded by deducting such fees from the company's recovery, as will be more thoroughly discussed *infra*.

The derivative claims involved a commercial transaction largely because many of the breaches were breaches of contract for violating the operating agreement, which constitutes a commercial transaction as a contract under Idaho law. *See Johannsen v. Utterbeck*, 146 Idaho 423, 432, 196 P.3d 341, 350 (2008) (holding that the breach of an operating agreement of a company formed for commercial purposes constituted a commercial transaction, thereby invoking the application of Idaho Code § 12-120(3). Even though limited claims of breach of fiduciary duty could be pursued as an operation of law, they also constitute a breach of the Source 1 operating agreement as "disabling conduct" and are thus grounded in a commercial transaction.

Additionally, the other breaches of fiduciary duty involving Hodge's role as liquidator also arose from a commercial transaction, as the auction was for the purchase of company assets and an auction clearly falls within the definition of a commercial transaction under Idaho Code § 12-120(3). *See Wakelam v. Hagood*, 151 Idaho 688, 695, 263 P.3d 742, 749 (2011).

To the extent that Appellant argues that the direct claims do not involve a commercial claim within the purview of Idaho Code § 12-120(3), it is clear that Prehn's claim arose out of a commercial transaction, as the claims involved a loan and salary from the business. The district court's reading and reliance on *Reynolds v. Trout Jones Gledhill Fuhrman, P.A.*, 154 Idaho 21, 293 P.3d 645 (2013) was on point with this case.

In *Reynolds*, the Court stated:

> "Idaho Code § 12-120(3) applies where "a 'commercial transaction' is integral to the claim, and constitutes the basis upon which the party is attempting to recover," and "[t]hus, as long as a commercial transaction is at the center of the lawsuit, the prevailing party may be entitled to attorney fees for claims that are fundamentally related to the commercial transaction yet sound in tort."

*Id.* at 26-27, 293 P.3d at 650-51. Clearly, the loan and back-salary were commercial transactions as defined by statute and were the gravamen of Prehn's direct claims as contemplated by statute and by applicable case law.

Appellant's analysis on *Carillo v. Boise Tire Co., Inc.*, 152 Idaho 741, 274 P.3d 1256 (2012) regarding the intent of the prevailing party is not instructive on this case, as the facts are easily distinguishable. In *Carillo*, the court clarified that both parties must simply enter into a transaction for a commercial purpose for Idaho Code § 12-120(3) to apply. *Id.* at 756, 274 P.3d at 1271. The plaintiff in *Carillo* obtained services for tires on a personal vehicle and thus, the transaction was for a personal benefit.

Contrarily, the transactions that form the bases of this lawsuit were not entered into for personal benefit. The derivative claims were brought on the behalf of the company and redressed harm incurred by Source 1 and its members due to Hodge's breach of contract and breach of his fiduciary duties. The auction was held for the commercial purpose of winding down and obtaining funds to distribute, in addition to allowing Source 1 members to buy assets for their new businesses. All parties to this suit entered into the underlying commercial transactions for commercial purposes.

As for the direct claims, Prehn entered into the loan and took a back-salary for the benefit of Source 1's financial viability. Source 1 accepted both for the purposes of continuing as a business and obtaining profitability. Furthermore, Appellant's failure to first pay back Prehn as a creditor after the vote for dissolution and instead make member distributions constitutes a clear violation of Section 14.2 of the Source 1 operating agreement, a contract that constitutes a commercial transaction as explained *supra*. Thus, the direct claims involve a commercial transaction in which both parties entered into for commercial purposes.

In sum, Respondent's claims, both direct and derivative, contain a myriad of breaches of the Source 1 operating agreement and other commercial transactions and as such, the claims are grounded in a commercial transaction that the parties entered into for a commercial purpose, which entitles Respondent to attorney fees and costs as the prevailing party. Therefore, the district court's award of attorney fees and costs pursuant to Idaho Code § 12-120(3) should be upheld.

## V. The district court ruled correctly in finding that Respondent is entitled attorney fees pursuant to Idaho Code § 30-6-906(2) in addition to the recovery of damages.

The district court also correctly concluded that Idaho Code § 30-6-906(2) does not preclude attorney fees under Idaho Code § 12-120(3), that the attorney fees should be in addition to damages awarded, and that these fees are properly to be assessed against Hodge.

Idaho Code § 30-6-906(2) provides a court discretion to award attorney fees and costs for successfully pursing a derivative claim as follows:

> "If a derivative action under section 30-6-902, Idaho Code, is successful in whole or in part, the district court **may** award the plaintiff reasonable expenses, including reasonable attorney fees and costs, from the recovery of the limited liability company." (emphasis added).

By the use of the word "may," it is clear that Idaho Code § 30-6-906(2) provides a court discretion in determining if attorney fees should be awarded under this provision. Thus, a court may find that a plaintiff prevailed on derivative actions but decline to award fees by the terms of this provision. However, there is no language contained in Idaho Code § 30-6-906(2) that precludes a court from awarding attorney fees and costs under other statutory or contractual bases where appropriate.

Although Appellant attempts to restrict any recovery fees and costs of derivative claims strictly to Idaho Code § 30-6-906(2), it is equally reasonable to assume that the statute simply provides for attorney fees from the recovery of the company if no other bases exist for the recovery of fees and costs. There are potential scenarios in which a derivative claimant could successfully bring derivative claims for the company that even if successful would not afford the claimants fees and costs by another statute or by contract.

For example, unlike the facts of this case, if a member of a company breached a fiduciary duty to a company by operation of law that was not governed by an operating agreement and was breached in a non-commercial context, no attorney fees and costs would be available under Idaho Code § 12-120(3) or by contract if successfully pursued by the derivative plaintiff. Assuming the case was not defended frivolously, it could be quite likely that the derivative plaintiff would not be entitled to any attorney fees except for Idaho Code § 30-6-906(2).

Additionally, it could be the case that only certain successful claims of a derivative plaintiff allow for an award of attorney fees and costs, while other successful claims do not. Thus,

it is not at all unreasonable to envision that the drafters of the statute created Idaho Code § 30-6-906(2) to serve as a fallback option for successful derivative plaintiffs who have no other bases for the recovery of attorney fees and costs for pursuing the claims.

Moreover, attorney fees and costs pursuant to Idaho Code § 30-6-906(2) are discretionary, whereas attorney fees and costs under Idaho Code § 12-120(3) are mandatory. Considering that the award of damages for the derivative claims were grounded in commercial transactions, declining to award attorney fees and costs under Idaho Code § 30-6-906(2) and instead awarding damages pursuant to Idaho Code § 12-120(3) against Hodge is the appropriate use of discretion based on the specifics facts of this case.

Additionally, if the court were to award attorney fees to be paid from the recovery by Source 1 rather than Hodge himself, the court would be conferring Hodge the same indemnification afforded by the operating agreement, from which he should no longer be granted due to his numerous breaches of fiduciary duty to the company. The Source 1 Operating Agreement is stated in relevant part as follows in § 15.3:

> "[T]he Company hereby indemnifies each Covered Person against and hereby agrees to defend and protect such Covered Person...to the extent that (a) such act or omission was related to the Company or its business, this Agreement, any related document, or any transaction or investment contemplated by this Agreement or any related document; (b) such act was committed or such omission was made (i) in good faith by such Covered Person, and (ii) in the reasonable belief that such act or omission was in the Company's best interests and within the scope of such Covered Person's authority, granted pursuant to this Agreement; and **(c) such act or omission did not constitute Disabling Conduct**." (emphasis added).

R., p. 99, § 15.3. The district court expressly found that Hodge breached his fiduciary duty to Source 1 and thereby breached the operating agreement, which constituted "disabling conduct" that disallows indemnification for its members. Thus, in breaching his fiduciary duty, and consequently the operating agreement by taking actions not in good faith or in the company's best interest, Hodge is no longer allowed indemnification and should be liable for attorney fees in addition to recovery due to Source 1. A deduction of attorney fees from the recovery simply does not provide the company its proper recovery, and provides Hodge indemnification for actions

taken which are in contravention to his duties to the company and to the operating agreement.

Further, awarding the attorney fees out of Source 1's recovery would set an unwanted precedent by insulating individuals who have breached their fiduciary duties from significant personal liability, as members could breach their fiduciary duties to the company and depend on attorney fees to be deducted from any recovery.

In this particular instance, vast resources were expended to successfully prosecute the derivative claims against Appellant. In fact, the attorney fees and costs were nearly equivalent to the damages awarded. *See* R., p. 1105. To permit attorney fees to be deducted from the award would essentially relegate Respondent's judgment to the amount of their attorney fees and costs necessary to properly pursue the derivative claims. A result of this nature would only discourage future litigants from bringing meritorious derivative claims, as any award of damages could easily become a wash after deducting attorney fees and costs from the award. As such, attorney fees and costs in addition to the award of damages is the proper remedy.

Every cause of action in which Respondent prevailed was grounded in a commercial transaction pursuant to Idaho Code § 12-120(3), which grants attorney fees in addition to the recovery of damages, rather than reducing the recovery of the company. In light of the bad conduct of Hodge as mentioned above, an award under the provisions of Idaho Code § 12-120(3) is a more appropriate award of fees and costs.

In this case, Hodge was solely responsible for harming Source 1 and causing the damages that were awarded under Respondent's derivative claims. To provide for attorney fees of Source 1's for its successful derivative claims by reducing its recovery would simply serve to reward the bad acts of Hodge in this matter and would essentially wash out all damages incurred with the attorney fees required to redress these bad acts. Respondent therefore requests that the Court uphold the attorney fees and costs as awarded by the district court.

## VI. ATTORNEY FEES AND COSTS UPON APPEAL

Respondents are asserting and claiming their reasonable attorney fees and costs incurred on appeal pursuant to Idaho Appellate Rules 40 and 41 for all issues raised on appeal. Respondent request that this Court affirm the trial court's awarding of attorney fees pursuant to

the bases of Idaho Code § 12-120(3) and 30-6-906(2) as the prevailing party.

As set forth *supra*, Respondent was clearly the prevailing party in this matter at trial and Appellant does not contest this on appeal. Costs on appeal are "allowed as a matter of course to the prevailing party unless otherwise provided by law or order of the Court." I.A.R. 40. As such, all reasonable costs of Respondent on appeal should be awarded.

As for attorney fees, the mandatory attorney fees afforded by Idaho Code § 12-120(3) to the prevailing party also govern on appeal. *Daisy Mfg. Co. v. Paintball Sports*, 134 Idaho 259, 263, 999 P.2d 914, 918 (Ct. App. 2010). Respondent is the prevailing party in this action and is therefore entitled to their reasonable attorney fees upon appeal via Idaho Appellate Rule 41.

Because of the reasons stated above, in addition to the applicable case law and arguments as stated *supra*, Respondent respectfully requests their reasonable attorney fees and costs upon appeal.

## CONCLUSION

Based on the case law, statutory authority and arguments as set forth above, Respondents respectfully ask this Court affirm the district court's ruling that: 1) Respondent properly pleaded and asserted a derivative claim on behalf of Source 1 against Hodge and Source 2; 2) that Hodge breached his fiduciary duties to Source 1 and its members in the manner that he orchestrated the asset auction and in failing to minimize the costs of completing existing purchase orders; 3) that the district court did not err as a matter of law in its award of attorney fees under Idaho Code § 12-120(3); and 4) that the district court properly awarded attorney fees against Hodge in favor of Source 1 in addition to Source 1's recovery for damages.

Dated: January 7th, 2016

Respectfully Submitted,

By: Matthew K. Taylor
MATTHEW K. TAYLOR
**ATTORNEY FOR RESPONDENT**

## CERTIFICATE OF SERVICE

I hereby certify that on this 7 day of January, 2016, I caused true and correct copies of this document to be served on the following individual by US Mail.

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